> commodity that should be priced by rule at affordable levels. Why not give deregulation of ISDN a chance?[124]

Proposing to regulate ISDN at the federal level is inconsistent with this direction.

B. Local Switching Costs Should Be Recovered In The Way They Are Incurred (¶¶ 71-79)

Currently, the local switching rate structure is limited to a per-minute-of-use-basis, regardless of the way local switching costs are incurred. When the costs are examined, it is clear that local switching is multi-dimensional. Switch connection costs such as line and trunk port costs, do not vary with usage as do those incurred in the switch processing function. The rate structure must reflect these differences.

Both line and trunk ports should be recovered on a flat-rated basis, to the extent they connect to dedicated trunk and line facilities. The costs of trunk ports are currently recovered in 2 different rate elements. Digital trunk ports (trunk cards) are assigned to Local Switching and are included in Account 2212. On the other hand, analog trunk ports, which are pieces of equipment which perform the same function as digital trunk cards, are assigned to Transport and included in Account 2232, which is currently part of the Transport Interconnection Charge. The functionality is the same but the Part 69 assignments are different.[125]

The switch fabric is shared by many carriers, and its costs (which vary with usage) must be recovered on a usage sensitive basis. Because by definition a shared facility is not dedicated to a particular customer, a flat-rated structure would result in high volume customers subsidizing low

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[124] Chairman Reed Hundt, "Media & Communications '96 Conference" September 17, 1996 "Competition: Walking the Walk and Talking the Talk"

[125] In section C (1) below, we note that those portions of the TIC that are readily identifiable as properly assignable to another rate element, should be reassigned to that element. That reassignment includes the $25M attributable to analog end office trunk ports.

volume customers. However, a trunk port serving common transport trunks[126] could also be considered a "shared facility"[127] since it carries traffic from many IXCs and the LEC itself. The traffic load placed on the common transport trunks, and their associated trunk ports is dynamic, changing from hour to hour, day to day and month to month. There is no practical nor fair way to assess to an IXC a flat monthly charge for the use of these trunk ports that are shared with other IXCs. Therefore, flat-rated charges for shared facilities are inappropriate.

The local switch must establish a call path through the network and keep that path open during the course of the call. For a call to be set up, the originating switch must return dial tone, receive digits dialed and consult various tables in the switch to determine the type of call, whether the call is interLATA, and determine where to send the call. It also needs to determine whether it needs to route the call to an access tandem or whether the carrier has facilities directly from the end office. The switch then needs to find an idle trunk and establish signalling to the carrier alerting the carrier's switch that the call will be coming. At this point, the switch then establishes the call path and receives the carrier's acknowledgment of receipt.

These call set up activities do not vary based on the number of calls, or the duration of those calls. A 10 second call incurs the same call set up costs as a 10 minute call. The current rate structure, which requires a rate level based on the average length of a call puts in place the uneconomic structure which ensures that some calls (short in duration) do not recover their costs, while long calls subsidize those calls. A structure which recognizes the way costs are incurred, via a per message call set up charge and a per minute duration charge is a rate structure where cost causers will pay

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[126] Like the trunk ports to which they connect, common transport facilities are by definition shared, and their costs must be recovered on a usage sensitive basis.

[127] *Notice* ¶ 73.

appropriate charges. One major problem with today's interstate switching rate structure is that short, transaction based calls (fax, credit card verification, debit card transactions, paging) are proliferating, and, due to the fact that call set up charges are not charged on each call, these transaction based calls are not paying local switching costs they incur.

It costs us almost five times more to set up a call than to provide a minute of use due to the heavy involvement of the switch processor in setting up calls. Permitting LECs to charge a separate per message call set up charge comports with sound economic principles and the Commission's goal of economic pricing based on cost causation principles.[128]

In California, we have had the call set-up and duration rate elements in place since January 1995, after the CPUC found that this rate structure better reflected cost causation principles than a simple minute of use structure.[129] The Commission asks if the call set- up charge should apply to call attempts or only to completed calls.[130] Since 1984 originating charges have applied to all originating access call attempts that are handed off to the POP, but are charged only to those terminating attempts that complete. We propose the same for the newly proposed call set up charges in the interstate jurisdiction as they do in California for intrastate access. In accordance with access pricing principles,[131] all originating attempts are billed because an originating attempt is deemed

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[128] Emmerson, pp. 8-9.

[129] Schedule CAL. P.U.C. No. 175-T, Section 6.8.3.

[130] *Notice* ¶ 76.

[131] Section 69.2 of the Commission's Rules (47 C.F.R. §69.2) defines *Access Minutes* or *Access Minutes of Use*. "On the originating end of an interstate or foreign call, usage is to be measured from the time the originating end user's call is delivered by the telephone company and acknowledged as received by the interexchange carrier's facilities connected with the originating exchange. On the terminating end of an interstate or foreign call, usage is to be measured from the time the call is received by the end user in the terminating exchange.

complete when it is handed off to an IXC. For terminating access, we bill only when the call completes to an end user. No change is needed to this access pricing principle.

The Commission's decision in the *Third Report and Order* does not obviate the need for a rate structure which permits carriers to charge a call set up charge in addition to the per minute of use charge. The *Third Report and Order* permits carriers to file for new services without going through the waiver process.[132] However, instituting a call set up charge is not a new service, it is a restructure of an existing service. As such, we would not be able to utilize the new procedures in the *Third Report and Order* to accomplish this rate structure change.

C. Transport Rates Should Be Structured To Reflect The Way Transport Costs Are Incurred, And Restructured So That Amounts In The TIC Are Reclassified To More Appropriate Rate Elements (¶¶ 80-122)

As with local switching, transport rates should reflect the way that costs are incurred. Because of the Commission's past decisions, transport rates require dedicated transport customers to pay for tandem switching (via the TIC) they do not use. The FCC correctly identifies that that to the extent a service involves dedicated facilities, such as entrance facilities and direct trunked transport, "flat-rates reflect the way incumbent LECs incur costs for dedicated facilities."[133] Flat-rated charges for these services are consistent with Pacific's state access prices,[134] and its interconnection agreements.[135]

Similarly, flat-rated charges should also be structured to recover costs for that portion of the tandem switch which is non-traffic sensitive. Like the local switching trunk ports, the trunk ports

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[132] Instead, a party must file a petition showing that the new service is in the public interest. *Third Report and Order*, ¶ 309.

[133] *Notice* ¶ 86.

[134] Schedule CAL. P.U.C. No. 175-T, Section 6.8.2.

[135] See note 100.

on the SWC-side of the tandem switch do not vary with usage, and are dedicated to particular customers. The ports on the end office side of the tandem, however, are shared (just as the end office ports connecting to common transport trunks are shared), and should be treated similarly by retaining a usage sensitive charge for that connection.

Moreover, the tandem switch, like the end office switch, incurs different types of costs for setting up calls and keeping calls in place. Like our proposal for local switching, the tandem switching charge should include a per message call set up charge and a per minute charge for the length of the call.

The Commission seeks comment on what rate structure or structures should be permitted for tandem-switched transport. We support a combination of flat-rated (between serving wire center (SWC) and access tandem) and usage sensitive (between access tandem and end office). We support the latter since the SWC to tandem facilities, like those that directly connect the SWC to an end office (and which are flat-rated), are dedicated to an IXC and do not vary with usage. On the other hand, the common transport facilities (those connecting the access tandem to an end office) are not dedicated to an IXC and need to be priced on a usage-sensitive basis for the same reasons described above regarding common transport trunk ports.

The Commission asks whether it is appropriate to recover some portion of tandem switching costs from direct trunked transport service customers since the tandem stands ready to serve those customers during peak periods.[136] We support such a pricing structure as economically efficient whether or not peak pricing is adopted. Dr. Emmerson states that "On efficiency grounds, customers with random demands should pay for the extra cost incurred due to the uncertain nature of their

[136] *Notice* ¶ 90.

capacity requirements. Thus, direct-trunked transport customers should have to pay a standby charge reflecting the added cost of accommodating their overflow traffic."[137]

1. The Transport Interconnection Charge ("TIC") Should Be Disaggregated And Costs Assigned To Their Proper Rate Elements. Residual Amounts Should Continue To Be Billed To Access Customers On A Bulk Billed Basis (¶¶ 96-122)

The TIC represents interstate costs appropriately recovered through access charges. In accordance with the Commission's obligations to permit access charges to recover costs allocated to the interstate jurisdiction through the separations process, the Commission must permit the TIC to be adequately and completely recovered through our interstate rates.

We agree with the Commission's tentative conclusion to reassign costs into their appropriate access services. The *Comptel* remand requires "a cost based alternative to the RIC [TIC], or to provide a reasoned explanation of why a departure from cost-based ratemaking is necessary and desirable in this context."[138] Cost based ratemaking is a central tenet in the Commission's *Notice*. No explanation has been proposed to justify a departure from this tenet. Thus, the TIC must be analyzed and costs in the TIC reassigned based on the appropriate rate element.

We have undertaken this analysis and can identify over 85% of the costs in our TIC. We believe that the 80% of the tandem revenue requirement contained in the TIC should be reallocated to the tandem switching rate. For Pacific, that amount represents about $28M of our $121M TIC. As we stated earlier in section B, approximately $25M of the TIC represents analog end office ports, which belong in the local switching rate. Other transport-related costs such as host-remote

[137] Emmerson, p. 9.
[138] *Comptel v. FCC*, 87 F.3d 522, 532 (D.C. Cir. 1996).

configurations and redefining tandem switched transport account for about $16M of the TIC and should be recovered in transport rate elements.

Various separations-related costs are contained in the TIC. These amount to about $40M, and are due to the way separations rules allocated COE maintenance, trunk termination count methodology, and interexchange cable and wire.[139] We expect that the upcoming proceeding on separations reform will ultimately deal with these costs for a long term resolution. We agree with the D. C. Court Of Appeals that the TIC "may in part reflect an excessive allocation of costs to interstate rather than intrastate services under the FCC's Part 36 rules; in any event they are real costs that would not otherwise be recovered."[140] As such their continued recovery, pending separations reform, is necessary and should be recovered via bulk billing as described below.

The remainder of the TIC, about $15M for Pacific, is unspecified. We support recovery for it (in addition to the $40M described above) via bulk-billing of access customers based on revenues and/or minutes of use.[141] Alternatively, if the Commission continues to use a productivity factor, we support a productivity offset where the productivity factor could be targeted to the remaining TIC, gradually eliminating it over a number of years.

This approach is proper whether or not a market-based or prescriptive approach to reform is chosen. The TIC revenue requirement is real and proper. It is therefore necessary that a viable recovery mechanism be provided.

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[139] See USTA Comments for further explanation of these items.

[140] *Comptel* at 530.

[141] We do not support a bulk billing based on presubscribed lines for these amounts. The costs are not loop related and there is no reason to burden the local loop with these costs.

D. SS7 Signalling (¶¶ 123-134)

This Commission seeks comment on how SS7 signalling costs should be recovered. While we generally support the Ameritech structure referenced by the Commission, a strict rate structure should not be imposed upon the industry.[142] Companies should have the flexibility to design a rate structure that best reflects the way SS7 technology is configured in that network.

The Commission realizes that some LECs may not have the appropriate monitoring equipment to measure SS7 usage.[143] We are one of those LECs. Installing the necessary equipment will cost millions of dollars. If the Commission mandates this expenditure for the measurement capability, these costs need to be recovered through discrete rate elements. The Commission must treat this service as a new service under the current rules and allow full cost recovery from all users.

E. New Technologies (¶139)

As we stated earlier in Section VI C 2, the Commission should not adopt any uniform access charge rules for new services as a result of new emerging technologies, as strict uniform rules which do not allow for cost recovery may stifle their deployment. The Commission should allow flexibility to individual companies as to how they choose to structure or recover the cost of new services based on their own unique market conditions. The introduction of new services has historically been slowed or brought to a standstill due to the standard, one size fits all, Part 69 approach. Maximum flexibility should be the road map of the future. Furthermore, we expect new services resulting from new emerging technologies to accelerate; regulatory processes will never change as fast as technology does. Many new services will be highly competitive and offered from

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[142] In addition, the *Notice* omits three elements contained in the Ameritech waiver: (1) signal formulation charge; (2) signal tandem switching charge, and; (3) optional parameters charge.

[143] *Notice* ¶ 137.

many different market players in a wide array of structures. These services should not be subject to any form of regulation. Allow the marketplace, not regulation, to determine how these services are structured and costs recovered.

XI. REGULATION OF TERMINATING ACCESS SHOULD BE SYMMETRICAL BETWEEN INCUMBENT AND NON-INCUMBENT LECS (¶¶271-281)

The *Notice* asks whether competitive LECs' terminating access services should be subject to different limits than incumbent price cap LECs' terminating access service.[144] As the *Notice* correctly notes the market factors affecting non-incumbent LECs terminating access services are the same as for incumbent LECs: the called party selects the carrier that provides terminating access and the calling party makes the decision to place the call.[145] Competitive LECs have the same incentives and abilities regarding terminating prices as do incumbent LECs. There is no rational basis for distinguishing between incumbent and non-incumbent LECs. Whatever regulation or market flexibility is applied to non-incumbent LECs should apply as well to incumbent LECs.

XII. THE COMMISSION MUST REMOVE UNREASONABLE DISCRIMINATION FAVORING ESPS IN ORDER TO CREATE PROPER INCENTIVES FOR NETWORK USE AND DEVELOPMENT AND TO COMPLY WITH THE ACT (¶¶ 282-290)

We recognize and appreciate that the Commission has started an *NOI* in CC Docket No. 96-263 on Usage of the Public Switched Network by Information Service and Internet Access Providers. We remain deeply concerned, however, that the current ESP exemption is plainly discriminatory and that market and economic conditions are exasperating the harmful effects of this

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[144] *Notice* ¶ 280.
[145] *Notice* ¶ 279.

discrimination on our business. The far better approach is for the Commission to end ESP discrimination at the same time that it reforms access. Our concern is heightened because this discriminatory treatment was always meant to be a temporary condition and should have been corrected years ago. Nonetheless the discrimination has continued for fourteen years, and there is no better time than now, as part of access reform, to end it. In this proceeding, the Commission should remove the ESP exemption at the same time that it addresses access charges for IXCs. To the extent that the Commission chooses to eliminate the discrimination through the *NOI*, however, it must act promptly in that proceeding.

The Commission cannot do anything about the past, other than correct misunderstandings, but it can encourage better solutions for the future. In its *Notice*, the Commission explains that "as part of this comprehensive proceeding, we must consider how our rules can provide incentives for investment and innovation in the underlying networks that support the Internet and other information services."[146] We agree that the Commission must consider these rule changes here, in this proceeding, because this is where the Commission is determining the regulations that will govern the interstate access networks that support information services. The current exemption for ESPs from payment of interstate access charges (1) is discriminatory and grants a preference in rates to ESPs as compared to other access users, (2) provides ESPs the strong incentive to use local business lines that are inefficient for their types of traffic, (3) provides LECs with little incentive for investment and innovation in more efficient services, and (4) does not allow cost recovery for expansion of the network for use by ESPs.

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[146] *Notice* ¶ 283.

Unlike 1983 when the Commission created the ESP exemption to foster the development of a fledgling market, the Enhanced Services industry is now well developed and too large to be exempt from access charges. We estimate that currently ESPs generate 25% to 35% as much traffic as IXCs on Pacific Bell's circuit switched network and that ESP traffic on Pacific Bell's circuit switched network will exceed 20 billion minutes in 1997. ESP traffic is growing dramatically faster than other traffic and, thus, is causing network capacity investments that otherwise would not be necessary.

Simply put, ESPs use more yet pay less than other network users. As explained below, this use is burdening the network and generating more costs for LECs that others are forced to pay. It would be difficult to find a clearer case of discrimination. It is well past the time when the discrimination should have ended, and the order in this proceeding is the proper vehicle to finally end it.

A. The Recent Selwyn/Laszlo Study Does Nothing To Explain Or Justify The Unlawful Discriminatory Treatment Afforded ESPs

The study that Lee Selwyn and Joseph Laszlo released January 22, 1997 on behalf of the Internet Access Coalition[147] -- apparently aimed at continuing the current discriminatory treatment for ESPs -- contains fundamental flaws. We briefly describe some of those flaws in this section and provide more details from Pacific Bell's situation in the sections that follow.

First, the study asserts that data traffic does not pose a significant threat to network integrity "at this time."[148] It attributes this network security to the nature of the network and Internet traffic. Actually, the reason that network integrity is protected in Pacific Bell's territory is that we are

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[147] Lee L. Selwyn, Joseph W. Laszlo, "The Effect Of Internet Use On the Nation's Telephone Network," January 22, 1997 ("Selwyn/Laszlo Study").

[148] *Id.* at v. *See also id.* at 3-4.

dedicated to investing hundreds of millions of dollars over the next few years in network expansion to handle enhanced services traffic. Incurring these costs is crucial to protect large numbers of telephone service subscribers, and there is no reason to discriminate in favor of ESPs and exempt them from having to pay for these costs.

Second, the study asserts that the LECs' sales of second lines to subscribers have produced additional LEC revenues that exceed the costs of accommodating Internet traffic.[149] Actually, the costs of second lines used with Internet access exceed the flat rates that Pacific Bell receives for the lines. Thus, to the extent these lines are used for Internet communications, they do not contribute to the recovery of Pacific Bell's investment that is needed to accommodate Internet traffic. If anything, they simply create more costs caused by ESPs yet paid by others.

Third, the study asserts that ESPs use the PSTN like business customers.[150] Actually, unlike business customers, ESPs do not use local business lines to originate calls and, thus, do not pay outbound usage charges. ESPs use the lines solely to receive calls from their subscribers, for which Pacific Bell receives no usage revenues. Moreover, on average, ESPs' data communications are substantially greater in quantity and duration than the communications of business customers and, thus, require more switch and interoffice network capacity, again increasing costs.

Fourth, the study asserts that the "long term solution for accommodating increased data traffic lies in the stimulation of competition and in the deployment of appropriate data-friendly network technologies, and not in the imposition of per-minute 'access charges' for use of the current voice-oriented circuit switched network."[151] Actually, the deployment of data-friendly network technologies

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[149] *Id.* at v., 21, 23-28, 36-37.
[150] *Id.* at 17-18.
[151] *Id.* at v. *See also id.* at 52.

is frustrated by the discriminatory exemption for one group of access users, the ESPs, from the charges paid by other access users. Allowing ESPs to have virtually free use of the circuit switched network gives them the strong incentive to continue to send all their traffic over that network rather than use more efficient "data-friendly" services for which they would have to pay charges that recover the LECs' costs. It also forces others to pay for the costs ESPs are causing.

B. Eliminating The ESP Exemption Will Remove Disincentives For Efficient Investment And Innovation In The Networks That Support Information Services (¶¶ 282-290)

The ESP exemption from access charges allows ESPs to use local business services instead of paying usage based charges for access to the public switched network. ESPs gain access to LEC loops and switches in order to offer services to end users, just like IXCs. One critical difference is that the current structure allows ESPs a lower, preferential rate which avoids the usage based charges that IXCs must pay for access.

Examination of Internet usage shows the added costs that ESPs cause. Internet access providers using Pacific Bell's network have an average call duration approximately seven times greater than the average call duration for all Pacific Bell's customers, and average peak-hour usage that is approximately five times greater.[152] Average Internet use is increased significantly by the 10% of Internet users who remain on-line over six hours per day, and pay nothing more for doing so.

According to the Selwyn/Laszlo Study, "the majority of ESP users fall into the range of 0 to 10 hours per month."[153] Accordingly, the effect on an "average" ESP end user's prices would be an increase of $3.00 per month from applying a hypothetical usage rate of $.01 per minute to ESPs' purchases of access, assuming a midpoint 5 hours per month use. This effect on ESP end-user prices

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[152] *See* Letter from Alan Ciamporcero, Pacific Telesis, to Jim Schlicting, FCC, June 28, 1996.
[153] Selwyn/Laszlo Study, p. 26.

also assumes that the ESP passes on 100% of the usage based prices to the end users but does not pass on any of the cost savings of moving to an access network architecture. By moving to that architecture, ESPs could benefit from significant operational cost savings by eliminating the need for points of presence in each local calling area. The ESP could pass on to its end users these cost savings, thereby offsetting some of the price increase. A cost-based access regime will ascribe costs to the cost causers: the 10% of ESP end users who account for "between 60% and 70% of total ESP hours of use."[154] This approach would create sound economic and technical incentives for offering new data access services for high volume users.

The effect of the unlawful discrimination favoring ESPs is made greater by the fact that some of the largest ESPs are also IXCs. The original value added network ("VAN") providers that the Commission benefited with the ESP exemption have been bought by, or merged with, IXCs (e.g., Sprint/Telenet, MCI/BT Tymnet). Sprint, for instance, buys Pacific Bell's service, bundles its own service, and sells the package to AOL. Pacific's revenues from Sprint, based on flat rate business lines, do not cover the cost of providing service to Sprint and represent only a small fraction of the revenues that Sprint gets from AOL for the package.

AT&T has over 600,000 subscribers to its Internet access service.[155] Moreover, AT&T is using this service primarily to protect its long distance business. It has offered five hours of Internet access each month for a year at no charge to subscribers of AT&T long distance, and unlimited use at $19.95 per month to subscribers of AT&T long distance, but at $24.95 per month for non-AT&T subscribers.[156] What possible sense does it make for Pacific Bell to subsidize AT&T via the ESP

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[154] *Id.*

[155] Jon Swartz, *"Troubles Increasing For AOL Another Breakdown, As State Prosecutors Consider Complaints,"* San Francisco Chronicle, January 24, 1997.

[156] *"AT&T Targets Masses With Free Access,"* Multimedia Week, March 4, 1996.

exemption, so that AT&T can subsidize its long distance business in order to protect against losses to competitors. These effects of the ESP exemption are clearly contrary to the Commission's goals to increase competition and benefit consumers.

The time is long past when the unlawful discrimination favoring ESPs should have ended. We cannot change the past, but we urge the Commission to allow better solutions for the future by removing the ESP exemption. The *Notice* misses the key point when it states, "The mere fact that providers of information services use incumbent LEC networks to receive calls from their customers does not mean that such providers should be subject to an interstate regulatory system designed for circuit-switched interexchange voice telephony."[157] So long as ESPs are provided strong financial incentives via the ESP exemption to use the circuit-switched network, they will continue to use it in a discriminatory manner that disadvantages LECs and other network users. LECs will continue to be required to expand their networks to accommodate this unreimbursed use, rather than being able to make greater investment in new network solutions. Funds could be much better spent to meet the economically efficient and longer term needs of ESPs and their customers, if the Commission removes the uneconomic incentives caused by the ESP exemption.

C. The Commission Must Act Now To End Unreasonable Discrimination Favoring ESPs (¶¶282-290)

Any conclusion in this proceeding to support the current ESP exemption would be an endorsement of continued unreasonable discrimination in violation of Sections 201 and 202 of the Act. The D.C. Circuit upheld the ESP exemption in 1984 against charges that it created unreasonable discrimination because it was a "graduated transition" that caused only "slight rate disparities," not a

[157] *Notice* ¶ 288.

permanent exemption that creates substantial disparities in payments. [158] We are confident that the D.C. Circuit would conclude differently now that the exemption (1) has been in place 13 more years without any "graduated transition" to remove discrimination, (2) exempts ESPs, which have become part of a huge industry and some of which are multi-billion dollar corporations, from payment of hundreds of millions of dollars in charges that other customers pay every year, and (3) provides ESPs with the incentive to use carriers' networks inefficiently.

The Commission has given the enhanced service market fourteen years to develop by exempting ESPs from the access structure. In 1983, the Commission adopted its access charge plan to establish the terms and conditions for interstate access "to remedy discrimination and preferences that violate Section 202(a) of the Communications Act."[159] The Commission did not create the ESP exemption in order to lock in one form of disparate treatment. Rather, the exemption was to be a part of a set of "transitional" rules designed to avoid "rate shock" by phasing-in access charges for interexchange resellers and ESPs, two classes of providers who had depended on low-priced business lines to obtain local access.[160] Although ordinary resellers soon lost their access charge exemption,[161] ESPs maintained theirs. In response to ESP arguments that their's was an "infant industry," the Commission initially reasoned that continuation of the exemption was justified by (1) the impending introduction of ONA requirements, (2) the BOC ability to enter into the information services business

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[158] *NARUC v. FCC*, 737 F.2d 1095, 1137 (D.C. Cir. 1984).

[159] *MTS and WATS Market Structure*, CC Docket No. 78-72, Phase I, *Third Report and Order*, 93 FCC 2d 241, 265 (1983) ("*Access Order*"), *modified on reconsideration*, 97 FCC 2d 834 (1984) ("*Access Reconsideration Order*"), *aff'd in principal part and remanded in part, National Ass'n of Regulatory Util. Comm'rs v. FCC*, 737 F.2d 1095, 1137 (D.C. Cir. 1984), *cert. denied*, 469 U.S. 1227 (1985), 110 FCC 2d 1222 (1985), *further reconsideration denied*, 102 FCC 2d 849 (1985).

[160] *See Amendments of Part 69 of the Commission's Rules Relating to Enhanced Service Providers,* CC Docket No. 87-215, *Notice of Proposed Rule Making*, 2 FCC Rcd 4305 (1987) ("*ESP Exemption NPRM*").

[161] *See ESP Exemption NPRM*, p. 4305.

pursuant to the modification of the MFJ, and (3) the relatively fragile and volatile state of the enhanced services industry.[162] Even after ONA was in place[163] and the BOCs had entered the information services business, the Commission continued to justify the access charge exemption as appropriate to avoid "disrupt[ing] the enhanced services industry during a time of rapid transition."[164] Rapid transition appears to be a permanent way of life for our industry, and can not possibly be considered a reasonable justification for continued discrimination.

In this proceeding, the Commission should remove the ESP exemption at the same time that it addresses access charges for IXCs. If, however, the Commission finds that removal of subsidies will take time, it could waive CCLC, TIC, and reserve deficiency amortization payments for ESPs. As a less beneficial interim alternative, the Commission could create an explicit subsidy to compensate LECs until the Commission removes the exemption.

It is essential that the Commission correct the problems caused by discriminatory pricing under the ESP exemption and at least take interim steps to achieve an equitable access structure in this proceeding. We believe that 14 years is more than long enough for a transitional period to bring ESPs into the access structure.

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[162] *Amendments of Part 69 of the Commission's Rules Relating to Enhanced Service Providers*, CC Docket No. 87-215, *Order*, 3 FCC Rcd 2631 (1988).

[163] Because of the ESP exemption, ESPs purchase few interstate ONA services, preferring the lower priced intrastate services that they can purchase under exchange tariffs.

[164] *Amendments of Section 64.702 of the Commission's Rules relating to the Creation of Access Charge Subelements for Open Network Architecture*, CC Docket No. 87-313, *Report and Order*, 6 FCC Rcd 4524, 4535, ¶ 60 (1991).

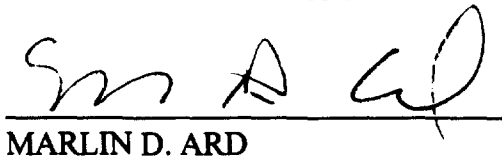
XIII. CONCLUSION

Access must be reformed. But, it must be reformed in a way that is consistent with the current state of competition, the existing separation rules, and the existing regulatory compact. The Commission does not need to prescribe rates, nor engage in activist administrative procedures. Instead the Commission needs to recognize that in areas facing competition, economics will set appropriate rules, and prices will be set that encourage efficiency. The Commission needs to take the leash off of our access prices and let competition work.

For the reasons given above, Pacific urges the Commission to adopt a market-based approach to access reform based on the USTA recommendations, modify the current access charge rate structure to more accurately reflect cost causation, implement mechanisms to assure that incumbent LECs will be able to recover all of their actual interstate costs, including embedded costs, and remove the ESP exemption.

Respectfully submitted,

PACIFIC TELESIS GROUP



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Date: January 29, 1997

DECLARATION OF TERRY R. ORR
IN SUPPORT OF COMMENTS OF PACIFIC TELESIS GROUP
January 29, 1997

I Terry R. Orr, declare as follows:

1. I am employed by Pacific Bell as Finance Director, Advanced Communications Network. In September of 1995, I assumed my present responsibilities. My prior responsibility was the review and assurance of Pacific Bell's capital and expense plans, including preparation of analyses to determine the book depreciation rates for capitalized assets.

2. In September of 1995, we discontinued use of Statement of Financial Accounting Standards No. 71 (SFAS 71) which prescribes how firms under regulation must prepare their financial statements. Regulated companies discontinue use of this standard for external reporting purposes when they judge that regulation may no longer assure recovery of investment. All seven Regional Bell Holding Companies have now discontinued SFAS 71 accounting. As a result of discontinuing SFAS 71, we took a one time accounting charge on our external financial reports of $5.7B pre-tax and $3.3B after tax during the third quarter of 1995. At that time our FCC reserve deficiency was $4.5B.

3. We quantified this impact on our depreciation reserve by determining which assets were being most impacted by increasing competition such as our copper cables, our switching and circuit equipment.

4. We then evaluated the amount of the reserve deficiency based upon shortening these lives to reflect the competitive marketplace in which we will be operating.

5. We chose lives within the range of lives corresponding to industry studies performed by Technology Futures, Inc.

6. We then calculated the reserve balance needed to retain the current depreciation expense levels given the shorter economic lives of our assets.

7. The reserve deficiency is the difference between our current book reserve and this calculated reserve amount. See Worksheet attached for the methodology of these calculations.

8. As shown on the attached Worksheet, our current reserve deficiency is $4.4B, the interstate portion of which is $1.0B.

I declare under penalty of perjury that the foregoing is true and correct. Executed at San Ramon, California on January 28, 1997.

Terry R. Orr

PACIFIC BELL
CALCULATION OF 1-1-97 RESERVE IMBALANCE

(000)

ACCOUNT NUMBER	CLASS OR SUBCLASS OF PLANT	1-1-97 ECONOMIC ARL	1994 PRESCRIBED FNS%	FCC 1994 PRES. DEPR RATE	CALCULATED RES%	1-1-97 FCC BOOK RES%	1-1-97 RES IMB %	Est 1-1-97 INVEST.	TOTAL RES IMB AMOUNT	TOTAL INTERSTATE PERCENT	TOTAL INTERSTATE AMOUNT
		A	B	C	D=100-B-(A*C)	E	F=D-E	G	H=F*G/100	I	J=H*I
2212	DIGITAL ELECT SWITCH	5.1	3.0	7.1	60.8	33.5	27.3	3,990,947	1,089,629	12.8	139,899
2232.12	DIGITAL CIRCUIT-OTHER	3.8	1.0	8.6	66.3	47.4	18.9	3,715,206	702,174	26.1	183,425
2232.2	ANALOG CIRCUIT-OTHER	2.7	0.0	7.4	80	63.5	16.5	485,211	80,060	26.1	20,914
2421.11	AER CABLE METALLIC-EXCH	6	-14.0	6.1	77.4	57.1	20.3	2,261,118	459,007	25.7	117,937
2421	AERIAL CA NONMETALLIC	12.7	-12.0	4.9	49.8	18.7	31.1	24,978	7,768	25.7	1,996
2422.11	UG CA METALLIC-EXCH	5.9	-12.0	4.8	83.7	51.3	32.4	3,028,946	981,378	25.7	252,155
2422	UG CA NONMETALLIC	11.8	-6.0	4.1	57.6	27.4	30.2	418,416	126,362	25.7	32,467
2423.11	BUR CA METALLIC-EXCH	5.8	-6.0	4.7	78.7	52.1	26.6	1,822,663	484,828	25.7	124,572
2423	BURIED CA NONMETALLIC	11.7	-3.0	3.5	62.1	23.8	38.3	39,189	15,009	25.7	3,856
2441	UNDERGROUND CONDUIT	33	-18.0	2	52	30.3	21.7	2,233,667	484,706	25.7	124,540
	TOTAL							18,020,341	4,430,821		1,001,573

DECLARATION OF RICHARD D. EMMERSON

I. INTRODUCTION AND SUMMARY

My name is Richard D. Emmerson. I am the President and CEO of INDETEC International, Inc. INDETEC International, Inc. provides consulting and training services to international telephone companies, Lucent Technologies, the United States Telephone Association (USTA), Bellcore, Commission staff members, partners and managers of large accounting and consulting firms, and interexchange companies (these services were formerly offered through INDETEC Corporation and Emmerson Enterprises, Inc.). I have a Ph.D. in economics from the University of California at Santa Barbara. During the past 20 years, I have taught in the Department of Economics at the University of California, San Diego, and I have consulted, testified, and taught courses on economic issues in telecommunications. Much of my consulting and teaching is about incremental cost study methodologies. My staff and I have conducted over one hundred projects involving incremental costs in telecommunications. My business address is 341 La Amatista, Del Mar, CA 92014.

I have prepared this declaration for Pacific Telesis in partial response to the Notice of Proposed Rulemaking ("NPRM") in CC Docket No. 96-262, released on December 24, 1996.[1] Pacific Telesis has asked me to comment on certain issues raised in the NPRM. These issues fall into the following four areas: (1) prescribing efficient rate structures for access services, (2) relying on market forces to govern access charges, (3) preventing anticompetitive conduct, (4) estimating the incremental costs of access services, and (5) pricing to recover common costs and embedded costs. The first area includes efficient pricing to recover common line costs, establishing multi-part tariffs for local switching, and charging direct trunking customers for the costs of tandem-switched transport. The

[1] In the Matter of Access Charge Reform, CC Docket No. 96-262, Notice of Proposed Rulemaking (rel. December 24, 1996).

second area involves identifying the determinants of market power and establishing criteria for relaxing or removing regulation, and the third area encompasses placing ceilings on access prices to prevent so-called price squeezes. The fourth and fifth areas concern specifying economically appropriate methods of measuring incremental costs and paying for depreciation reserve deficiencies and stranded costs.

My principal conclusions and recommendations may be summarized as follows:

1. The current rate structure for exchange access services is economically inefficient. Ideally, the Commission should permit Pacific Bell and other incumbent local exchange companies ("LECs") to increase the subscriber line charge ("SLC") and to deaverage SLCs geographically. At a minimum, SLCs should be geographically deaveraged. If the SLC is not increased, then common line costs should be recovered by bulk billing interexchange carriers ("IXCs") on the basis of presubscribed lines.

2. The Commission should allow Pacific Bell and other incumbent LECs to establish multi-part tariffs for local switching rates. Multi-part rate schedules for local switching services correspond more accurately to the variation in the incremental costs of such services. Specifically, the Commission should permit Pacific Bell and other incumbent LECs to charge a combination of flat rates and usage charges for local switching and differentiate usage charges on the basis of call setup and subsequent minutes.

3. Direct-trunked transport customers should have to pay for the additional tandem switching costs incurred because Pacific Bell and other incumbent LECs must supply extra capacity to carry overflow traffic at peak periods. A standby charge applied to direct-trunked transport is an economically appropriate method of paying for the added costs imposed by maintaining a security margin for overflow traffic.

4. The key to securing effective competition in access services is overcoming the entry-deterring effect of sunk costs associated with local exchange facilities, and the Telecommunications Act of 1996 ("the Act") has provided this key in the form of its open access provisions. Pacific Bell has already entered into eighteen interconnection arrangements through voluntary negotiation and compulsory state arbitration. The Commission should allow the implementation of these arrangements to bring effective competition to access services and not resort to additional tests and standards.

5. Most of the competitive tests set out in the NPRM are unnecessary, misleading and unduly burdensome. Market share is an unreliable indicator of market power and completely misleading in regulated industries. Market demand elasticity is simply not an indicator of market power. In contrast, supply elasticity is a good indicator of market power, but measuring supply elasticity in access services is unnecessary. The Act's open access provisions have already increased that elasticity. Evidence of actual access prices falling below an administratively determined price cap is an improper test of competitiveness. Finally, using performance standards such as price-cost margins to assess the extent of market power over access services would lead to "endless and inconclusive wrangling." Access prices exceeding incremental costs are not indicative of the absence of competition but consistent with the need for LECs such as Pacific Bell to recover their substantial shared and common costs.

6. The Act's open access standards and Pacific Bell's progress in concluding interconnection contracts constitute ample evidence that entry barriers affecting access services have fallen considerably. This fact strongly suggests that a reasonable two-phase test of competitiveness for access services includes: (1) in-place interconnection arrangements and (2) evidence that local exchange competitors are using such arrangements. Pacific Bell has already passed the first phase of this test with its eighteen completed interconnection contracts, several of which satisfy Section 271's 14-point competitive checklist.

7. The NPRM's apparent concern about call externalities is misplaced. Call externalities do not impart appreciable differences in market power over originating and terminating access services.

8. LECs such as Pacific Bell do not have an inherent competitive advantage when selling both local exchange and access services. Arguments to the contrary ignore the opportunity cost of foregone access revenues.

9. Pacific Bell and other incumbent LECs have neither the incentive nor the ability to conduct anticompetitive price squeezes. Pacific Bell could not execute such a squeeze because it lacks the requisite market power. Even if Pacific Bell held significant market power, it could not successfully squeeze competitors out of the industry. With no prospect of success, Pacific Bell lacks the incentive to even attempt a price squeeze. Regardless, existing safeguards are sufficient to prevent Pacific Bell from imposing a price squeeze on its future interLATA competitors.

10. When estimating costs for pricing purposes, the various cost proxy models as they are configured today produce estimates that are inherently inferior to the estimates produced by the standard incremental cost methodology such as Pacific Bell uses. On the other hand, the methodology behind the best of today's cost proxy models, if not the specific results, may be suitable for estimating universal service subsidy requirements or for providing general cost "benchmark" information.

11. The Commission should not promulgate rules forcing access prices to equal TSLRIC or artificially limiting access markups. First, unless the Commission allows the SLC to rise, incumbent LECs like Pacific Bell must recover common line costs through charges assessed against IXCs. Second, Pacific Bell and other incumbent LECs must recover unattributable shared and common costs throughout the full array of their services, including exchange access and unbundled network elements. Third, incumbent LECs like Pacific Bell must also recover through access and interconnection charges the embedded costs which they have prudently incurred fulfilling their public service obligations, including depreciation reserve deficiencies and stranded costs.

12. The difference between the prices charged for access services and unbundled network elements should not exceed the difference in incremental costs. Maintaining unbundled network element prices below a level justified by the incremental cost differential seriously misallocates resources and inefficiently threatens the earning power of Pacific Bell and other incumbent LECs.

II. RATE STRUCTURE MODIFICATIONS

A. Common Line

Section III of the NPRM solicits comments on alternative carrier common line ("CCL") charge structures. It concludes that the current CCL structure is economically inefficient because it does not correspond to the way LECs incur common line costs.[2] I agree. The most efficient method of recovering common line costs is through flat monthly charges paid by end users. These flat monthly rates should also vary with geographic differences in loop costs. Consequently, the Commission should remove or raise the caps

[2] NPRM, ¶ 58.